STATE OF NORTH DAKOTA

BISMARCK, NORTH DAKOTA

REPORT OF EXAMINATION

OF

NORTHEAST MUTUAL INSURANCE COMPANY
CANDO, NORTH DAKOTA

AS OF
DECEMBER 31, 2003

STATE OF NORTH DAKOTA

DEPARTMENT OF INSURANCE

I, the undersigned, Commissioner of Insurance of the State of North Dakota do hereby certify that I have compared the annexed copy of the Report of Examination of the

Northeast Mutual Insurance Company

Cando, North Dakota

as of December 31, 2003, with the original on file in this Department and that the same is a correct transcript therefrom and of the whole of said original.

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my official seal at my office in the City of Bismarck, this _____ day of _______________, 2004.

____
Jim Poolman
Commissioner of Insurance

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Cando, North Dakota
June 30, 2004

Honorable Jim Poolman
Commissioner of Insurance
North Dakota Insurance Department
600 East Boulevard Avenue
Bismarck, ND 58505-0320

Dear Sir:

Pursuant to your instructions and in accordance with the North Dakota Insurance Code, an examination was made of the condition and affairs of the

Northeast Mutual Insurance Company
Cando, North Dakota

as of December 31, 2003.

This represents the first examination of Northeast Mutual Insurance Company, Cando, North Dakota, hereinafter referred to as the "Company".

SCOPE OF EXAMINATION

This examination was a financial condition examination conducted in accordance with N.D. Cent. Code § 26.1-03-19.3 and observed guidelines and procedures contained in the NAIC *Financial Condition Examiners Handbook*. The examination was conducted to determine the Company's financial condition, its compliance with statutes, and to review the corporate affairs and insurance operations. This statutory examination covers the period from April 8, 1999, to and including December 31, 2003, including any material transactions and/or events occurring subsequent to the examination date and noted during the course of this statutory examination.

HISTORY

The Company was formed on April 8, 1999, through the consolidation of Cavalier County Farmers Mutual Insurance Company of Osnabrock, North Dakota and Farmers Mutual Fire, Lightning and Cyclone Insurance Company of Towner County, of Cando, North Dakota. The new insurance company was named Northeast Mutual Insurance Company.

The Company was organized to insure, make contracts of insurance, re-insure or accept reinsurance on any portion thereof, in all forms which are now authorized, or which may hereafter be authorized, under the laws of the State of North Dakota relating to county mutual companies as provided for in N.D. Cent. Code Chapter 26.1-13.

Effective May 12, 1999, Pembina County Mutual Insurance Company, Cavalier, North Dakota merged into the Company.

Effective June 27, 2001, LaMoure-Greenfield Mutual Insurance Company, LaMoure, North Dakota merged into the Company.

MANAGEMENT AND CONTROL

The Company is controlled by its membership. Any person owning property within the limits of the territory within which the Company is authorized to transact business may become a member of the Company and be entitled to all the rights and privileges appertaining thereto by insuring therein. No person who does not reside within such territorial limits shall become a director of the Company.

Directors

The management of the Company's affairs, business, and property is vested in a Board of Directors. The number of directors shall be determined each year at the annual meeting of members and shall not be less than 5 nor more than 15, a majority of whom shall constitute a quorum to do business. The directors shall be elected at the annual meeting for a period of three years and until their successors are elected and qualified; one-third of the directors shall be elected at each annual meeting.

Directors duly elected and serving the Company at December 31, 2003, were as follows:

Name and Residence	Term Expires	Occupation
Rodney A. Buck Oakes, ND	2005	Businessman
John W. Heldt Munich, ND	2004	Retired
David Monson Osnabrock, ND	2005	Education
Charles I. Ottem Osnabrock, ND	2006	Farming/Insurance
Keith Duchscher Rugby, ND	2005	Insurance
David Kronebusch Marion, ND	2004	Businessman
Mark Morrison Cavalier, ND	2005	Farming
Gerald E. Peterson Langdon, ND	2004	Retired
Archie Forseth Sarles, ND	2006	Insurance
R.C. McLeod Cando, ND	2006	Retired
Larry L. Murie Langdon, ND	2004	Farming/Insurance
Arthur Torkelsen Cando, ND	2006	Retired

Officers

Officers are elected annually by the Board of Directors at the meeting of the Board of Directors held after the annual meeting of the policyholders. Officers serving at December 31, 2003, were as follows:

Name	Office
Gerald E. Peterson	President
John W. Heldt	Vice President
R.C. McLeod	Secretary and Treasurer

Executive Committee

The President, Vice President and the Secretary-Treasurer shall constitute an executive committee which shall have authority to act for the company in emergency matters arising between meetings of the Board of Directors and to transact such other business as may be delegated to it by the Board from time to time.

CORPORATE RECORDS

The minutes of the meetings held by the membership and directors during the years under examination were reviewed for compliance with the Articles of Incorporation, Bylaws, and statutory requirements.

Members

During the period under examination the annual meetings of the policyholders were held on the following dates: June 25, 1999; June 30, 2000; June 29, 2001; June 28, 2002; and June 27, 2003.

Directors

During the period under examination, the Board of Directors held six meetings in 1999, three meetings in 2000, 2001, and 2002 and two meetings in 2003.

Articles of Incorporation and Bylaws

At the June 29, 2001, annual meeting of the policyholders, Article III of the Articles of Incorporation was amended changing the Company's authorized territory from 20 counties to 30 counties.

The following is a list of the differences noted with regard to the corporate records:

1. Prior Approval of Investments: The minutes of the Board of Directors do not reflect approval of investment transactions as required by North Dakota insurance law. N.D. Cent. Code § 26.1-05-18 requires the Board of Directors or a Board-appointed Investment Committee to authorize an investment transaction before it is made. The North Dakota Insurance Department has deemed board or committee approvals on no less than a quarterly basis to be in compliance with the law when the requirements of N.D. Admin. Code § 45-03-12-05 are followed. **It is recommended that the Company implement a procedure pursuant to N.D. Admin. Code § 45-03-12-05 to provide for quarterly authorization of investment transactions by the Board of Directors.**

2. Borrowed Money: The Board of Directors did not authorize a $55,000 loan from First State Bank, Cando in 1999 as required by N.D. Cent. Code § 26.1-05-18. **It is recommended that no loan be made unless the loan first has been**

authorized by the Board of Directors or a Board-appointed investment committee.

AFFILIATES

Risk Management Services (RMS) was formed in 2000 to provide on-site property risk reviews and claim adjustment services to other entities including county mutual insurance companies and other insurance companies. RMS is not a separate legal entity but is controlled by the Company by virtue of common management.

The Company's employees perform various administrative services for RMS and the Company's facilities and office equipment are also used by RMS. During the period under examination, RMS did not reimburse the Company for the services and equipment provided by the Company. **It is recommended that the Company and RMS enter into a facilities management and service agreement which includes a description of the services provided, the method used to determine the cost of those services and payment terms.**

The Company records RMS's transactions in its accounting system (OASIS software) along with its own transactions. Consequently, the Company's December 31, 2003, trial balance used to prepare the 2003 Annual Statement contained the financial condition and operating results for both entities. The Examiners did not attempt to identify RMS transactions or balances from the Company's as those procedures were deemed beyond the scope of this examination. **It is recommended that the Company maintain a separate recordkeeping system for RMS and that the Company report only the financial transactions and balances for the Company's operations and activities in its statutory annual statement.**

FIDELITY BOND AND OTHER INSURANCE

At December 31, 2003, there was in force a name schedule fidelity bond in the amount of $25,000 covering loss of money or property due to actions taken by the Company's office manager. The coverage does not meet the $75,000 minimum amount of fidelity insurance recommended in the NAIC's *Financial Examiners Handbook.* **It is recommended that the Company increase its fidelity bond to the $75,000 amount recommended by the NAIC.**

The Company also had in force a directors and officers liability insurance policy providing a $1,000,000 limit of liability each policy year. Each claim is subject to a $5,000 deductible. The policy provides coverage for errors or omissions in the performance of professional services and wrongful acts of a director or officer while acting solely in their individual or collective capacities as directors and officers.

Insurance coverage on the Company's home office building and investment real estate was reviewed and appeared to be adequate.

TERRITORY AND PLAN OF OPERATION

At December 31, 2003, the Company had 96 licensed agents and was authorized to transact business within the following counties:

Barnes	Benson	Bottineau	Cass	Cavalier
Dickey	Eddy	Emmons	Foster	Grand Forks
Griggs	Kidder	LaMoure	Logan	McIntosh
McHenry	Nelson	Pembina	Pierce	Ramsey
Ransom	Richland	Rolette	Sargent	Steele
Stutsman	Towner	Traill	Walsh	Wells

GROWTH OF THE COMPANY

The financial growth of the Company for the five-year period ended December 31, 2003, was as follows:

Year	Admitted Assets	Total Liabilities	Surplus as Regards Policyholders	Net Premiums Written ***	Underwriting Deductions	Investment and Other Income	Net Income (Loss)
1999	$1,633,292	$364,420	$1,268,872	$361,234	$692,730	$ 130,979	$(200,517)
2000	1,565,667	416,064	1,149,603	438,642	537,322	37,072	(61,608)
2001	1,898,930	615,757	1,283,173	678,490	667,268	136,952	148,174
2002	2,531,279	900,964	1,630,315	1,195,515	837,012	260,654	619,157
2003	2,890,014	1,092,797	1,797,217	1,419,760	1,400,375	180,017	199,403

Data with respect to the years 1999 through 2002 is compiled from home office copies of the filed Annual Statements. Data for the year 2003 reflects the results of this examination. The operational results for years 1999 through 2002 are presented on a cash basis; year 2003 is presented on a modified cash basis.

The consolidation of Farmers Mutual Fire, Lightning and Cyclone Insurance Company of Towner County and Cavalier County Farmers Mutual Insurance Company occurred in 1999. The Company merged with Pembina County Mutual Insurance Company in 1999 and with LaMoure-Greenfield Mutual Insurance Company in 2001. The financial condition of those companies near the merger date is as follows:

	Admitted Assets	Liabilities	Surplus
Farmers Mutual *	$1,026,602	$123,402	$ 903,200
Cavalier *	559,390	80,535	478,855
Pembina *	222,853	267,732	(44,879)
LaMoure-Greenfield **	370,948	325,807	45,141

* Source: 1998 Annual Statement
** Source: 2000 Annual Statement
*** Includes liability premiums for year 2003

REINSURANCE

The Company's reinsurance treaty in force at December 31, 2003, is summarized below.
Nonaffiliated Ceding Contract:

1. Type: Excess

Reinsurer: Grinnell Mutual Reinsurance Company

Scope: Fire, Lightning and Extended Coverages; Windstorm and Hail Coverage; Comprehensive Personal Liability and Farmers Comprehensive Personal Liability

(A) Individual Occurrence of Loss Excess – Covers all risks written by the Company in excess of a $100,000 retention subject to the following limits:

Dwellings	$500,000
Farm Outbuildings	$750,000
Livestock/Poultry/Horse Operations	$500,000
Commercial and Public Property	$500,000

(B) Aggregate Excess – Provides coverage 100 percent of the Company's aggregate net losses in excess of a defined retention limit. The retention limit for 2003 was $850,288.

(C) Liability – The reinsurer assumes 100% of the liability for comprehensive personal and farmers comprehensive personal liability coverages.

Premium:

(A) Individual Occurrence of Loss Excess – The 2003 annual premium was $0.1453 for fire and $0.0309 for wind per $1,000 of adjusted gross fire risks in force.

(B) Aggregate Excess – The 2003 annual premium was $.5134 per $1,000 of gross fire risks in force.

(C) Personal Liability – The reinsured shall cede 100% of the premium to the reinsurer.

Commissions: 20% commission on liability premiums ceded.

Termination Date: The agreement may be terminated only as of the last day of any calendar year by either party upon 90 days notice.

The agreement contained the insolvency clause required by N.D. Cent. Code § 26.1-02-21 and all of the clauses required by the NAIC's *Accounting Practices and Procedures Manual* except for the "entire contract" clause. **It is recommended that the Company amend the reinsurance agreement with Grinnell Mutual Reinsurance Company to include an "entire contract" clause.**

ACCOUNTS AND RECORDS

The Company's accounting procedures, internal controls, and transaction cycles were reviewed during the course of the examination and a trial balance as of December 31, 2003, was extracted from the general ledger and traced to the appropriate schedules of the Company's amended 2003 Annual Statement, which was filed on April 8, 2004. Revenues and expenses were test checked to the extent deemed necessary.

Premium and policy related transactions along with loss statistical records and accounting transactions are processed using Oasis, an application software program purchased from Grinnell Mutual Reinsurance Company. The Company's hardware at December 31, 2003, consisted of approximately seven personal computers, one server and five laptops.

During the period under examination, the Company transitioned its accounting records from a manual recordkeeping system to the Oasis software program. In 2003, the Company still maintained manual records (including cash receipts and cash disbursements journals) but prepared its 2003 annual statement using the trial balance generated by Oasis and output from that system as the principal source for 2003 transactions and year end balances.

Workpapers show that the Company compared amounts on the trial balance generated by Oasis to balances on the manual recordkeeping system searching for omissions and inaccurate amounts when it tried to balance its 2003 Annual Statement (see Item No. 1 below). Those workpapers evidence that some transactions were recorded in one system but not the other and some transactions were apparently not recorded in either the manual records or Oasis. The inaccuracies and omissions arose principally because two employees recorded cash receipts and cash disbursements in 2003 in separate recordkeeping systems but did not reconcile totals from one system to the other. The use of dual unreconciled accounting systems and lack of centralized control and responsibility for the accounting records and financial statements contributed significantly to the numerous accounting differences noted in this report. Another significant contributing factor was the Company's unfamiliarity with the output from Oasis. Year 2003 represented the first year the Company used output from that system to prepare its annual statement. **It is recommended that the Company eliminate the manual recordkeeping system and strive to record all transactions in Oasis. It is also recommended that the Company establish clear job duties and responsibilities which will create an environment conducive to producing reliable accounting records.**

The Examiners noted the following differences with respect to the Company's accounts and records:

1. <u>Ledger Assets Reconciliation</u>: The Company used a "plug" of $6,700.42 to agree the balance on line 44, page 2, of its 2003 Annual Statement with total ledger assets reported on line 12 of page 3. The Company had no support for the $6,700.42. In addition to that item, the Examiners noted the following other differences:

    - Two amounts in the December 31, 2003 trial balance were not reported in the 2003 annual statement. The total of those items was $2,782.40.

    - Two amounts reported in the 2003 annual statement were not in the Company's manual cash receipt or cash disbursement journals nor were those amounts recorded in the computerized transactions processed by the Oasis accounting program. The total of those amounts was $6,648.

- Uncollected premiums were not reported as a ledger asset in the 2003 Annual Statement and as a result December 31, 2003, ledger assets were understated by $164,390. (See also Uncollected Premiums)

2. Liability Premiums: The Company writes comprehensive personal liability and farmers comprehensive personal liability business on a direct basis and cedes 100% of that business to Grinnell Mutual Reinsurance Company less a 20% ceding commission. The Company incorrectly reported the liability business on line 12, page 2, of its 2003 Annual Statement in the net amount of $59,424.64 (see below) as a write-in income item instead of on line 1 as direct premiums written. The $59,424.64 is composed of the following items and amounts from the December 31, 2003, trial balance:

Liability Premiums	$200,911.21
Miscellaneous	3,705.07
Liability Reinsurance Premiums Ceded	(145,191.64)
Net	$ 59,424.64

The Examiners reclassified liability premiums written and liability premiums ceded as direct business transactions in the financial statements of this report. The Examiners also treated liability premiums as taxable premiums when recomputing the Company's premium tax returns for the five-year period under examination since the Company also incorrectly reported liability premiums as a write-in item in the 1999-2002 annual statements.

3. Expense Classification – Loss Adjustment Expenses: The Company reported loss adjustment expenses of $146,287 on line 20, page 2, of its 2003 Annual Statement. That amount included training costs for adjustors and risk inspectors, and the cost of risk inspections in addition to expenses paid for claims adjusting. Review of a detailed printout showed that some of the expenses allocated to loss adjustment expenses also represented payments for inspections and claim adjustment services conducted by RMS for other insurers. The exact amount of those services could not be readily determined nor could the Examiners readily determine the overstatement to loss adjustment expenses. **It is recommended that the Company report only claim adjustment expenses on line 20 in accordance with C*ounty Mutual Annual Statement Instructions.***

4. Supporting Documentation: Detail listings supporting amounts reported in the Annual Statements or premium tax statements were not always retained or if available did not always agree with reported amounts. The following examples were noted in which documentation was not available or did not agree with reported amounts:

   Commissions Payable
   Premium Tax Credits
   Cost of Home Office Building
   Unpaid Losses

It is recommended that the Company maintain adequate records and workpapers to support the detail of all accounting transactions, enabling verification of the year-end statement values. Company management should perform a periodic review to determine that these records are accurate, sufficiently detailed, and retained in orderly, safe storage with appropriate retention periods

In the course of performing audit procedures, the Examiners considered internal controls. The following is a list of policies and procedures that the Examiners recommend the Company implement:

1. Capitalization Policy: The Company included several real estate expenditures under $100 in determining the actual cost of the new home office building. *County Mutual Annual Statement Instructions* state that items under $100 and with a useful life of less than one year should not be capitalized. **It is recommended that the Company establish a capitalization policy for real estate and furniture, fixture and automobiles that excludes all items under $100 and expenditures with a useful life of less than one year.**

2. Cash Disbursements: The following items were noted:

   - At December 31, 2003, five employees had check issuance authority.
   - The Company required only one signature for checks issued.
   - The Company does not prohibit issuing checks to “cash”.
   - The Board of Directors does not authorize bank accounts or check signing authority.

   It is recommended that the Company limit the number of employees authorized to withdraw funds from the checking account to no more than two employees authorized by the Board of Directors. In addition, it is recommended that the Company require two signatures on all checks, or on all checks in excess of a minimum amount established by the Board. The Examiners also recommend that the Company prohibit issuing checks to “cash”.

3. Bank Reconciliation: The bank reconciliation is currently prepared by employees who record transactions and who also have authority to issue checks. **It is recommended that the bank reconciliation be prepared by someone who does not record transactions and does not issue checks.**

4. Bank Custodian/Broker Dealers: The Company’s securities were held by four custodians at December 31, 2003. Management did not appear to evaluate the financial condition and capabilities of security custodians and broker/dealers prior to entering into a business relationship or on a periodic basis after it had established a business relationship. **It is recommended that the Company evaluate the financial condition and capability of the custodian before establishing a business relationship and on a periodic basis while continuing the business relationship.**

FINANCIAL STATEMENTS

The following statements reflect the financial condition of the Company as of December 31, 2003, as determined by this examination and its operating results for the year then ended.

Assets, Liabilities, and Surplus

Assets

LEDGER ASSETS:			
Bonds	$1,378,803.13		
Stocks	649,577.05		
Real Estate	73,341.82		
Cash on Hand and Checking Account	209,928.22		
Cash on Deposit	357,682.88		
Uncollected Premiums	164,390.08		
Furniture, Fixtures, Automobiles	74,599.26		
Other Assets	17,824.72		
TOTAL LEDGER ASSETS		$2,926,147.16	
NONLEDGER ASSETS:			
Interest Due and Accrued on Bonds	15,696.69		
Dividends Due and Accrued on Stocks	610.10		
Market Value of Stocks over Book Value	49,468.30		
TOTAL NONLEDGER ASSETS		65,775.09	
DEDUCT: ASSETS NOT ADMITTED			
Premiums Over 90 Days Due	5,123.63		
Furniture, Fixtures, Automobiles	74,599.26		
Real Estate	4,360.00		
Other Assets	17,824.72		
TOTAL NONADMITTED ASSETS		(101,907.61)	
TOTAL NET ADMITTED ASSETS			$2,890,014.64
LIABILITIES:			
Unpaid Losses	$54,981.43		
Unpaid Loss Adjustment Expenses	2,115.00		
Unearned Premium Reserve	858,541.88		
Commissions Due and Pay. to Agents	78,478.96		
Advance Premiums	13,594.79		
Unpaid Taxes	30,364.40		
Unpaid General Expenses	11,812.29		
Amounts Withheld for Account of Others	4,084.74		
Federal Income Taxes	5,000.00		
Stale-Dated Outstanding Checks	2,000.00		
Reinsurance Premiums Due and Payable	31,824.23		
TOTAL LIABILITIES		1,092,797.72	
			1,797,216.92
SURPLUS TO POLICYHOLDERS			

TOTAL LIABILITIES AND SURPLUS	$2,890,014.64

Statement of Income and Disbursements

INCOME:			
Gross Premium Income		$1,862,955.71	
Less: Return Premiums		37,510.67	
Premiums for Reinsurance Ceded		405,684.64	
NET PREMIUM INCOME			$1,419,760.4
Interest on Bonds		$51,204.92	
Dividends on Stocks		11,052.79	
Gross Rent from Co. Prop, Incl. $ 9,220.00 for Co.		14,067.00	
Interest on Cash on Deposit		7,676.01	
Profit on Sale or Maturity of Ledger Assets		(6,587.50)	
Commissions and Service Fees Received		42,397.53	
Miscellaneous Income/Inc. in Ledger Liabilities		17,299.86	
Adjusting and Inspecting		42,906.83	
TOTAL INCOME RECEIPTS			1,599,777.84
DISBURSEMENTS:			
Gross Losses Paid and Incurred in 2003	$351,579.94		
Gross Losses Pd. in 2003 But Incurred in Prior Yrs.	24,311.22		
Deduct: Salvage and Subrogation	32,367.50		
NET LOSSES PAID		$343,523.66	
Claim Adjustment Expenses		146,287.41	
Commissions Paid to Agents		277,305.74	
Directors Fees and Expenses		7,002.97	
Salaries to Employees		207,220.00	
Printing, Stationary, and Office Supplies		12,381.13	
Rent and Rent Items, incl. $9,220 for Co.		9,220.00	
Real Estate Expenses		17,813.20	
Taxes on Real Estate		1,622.74	
State and Local Insurance Taxes		26,470.00	
Insurance Dept. Licenses and Fees		2,986.70	
Payroll Taxes		23,978.53	
Federal Income Taxes		162,089.39	
Legal Fees and Auditing		15,589.71	
Travel and Travel Items		12,179.79	
Advertising		8,218.05	
Dues and Donations		6,848.95	
Equipment		12,919.27	
Insurance and Bonds		9,120.87	
Postage, Telephone and Bank Charges		20,942.18	
Employee Relations and Welfare		35,668.30	
Data Processing Expenses		13,433.07	
Miscellaneous		13,036.84	
Investment Expense		14,516.32	
TOTAL FUNDS DISBURSED			1,400,374.82
NET INCOME			$ 199,403.02

COMMENTS TO THE FINANCIAL STATEMENTS

Financial statement balances at December 31, 2003, are commented upon only if financial changes, recommendations, or special explanations are considered necessary.

Many of the comments that follow pertain to non-compliance with *County Mutual Annual Statement Instructions* in completing various exhibits and schedules in the annual statement. The instructions provide detailed guidance regarding the classification of expenditures, valuation of accounts, and specific details for groupings for the individual schedules and sections. **It is recommended that the Company thoroughly review the Annual Statement Instructions to insure that its annual statement is completed in accordance with those instructions.**

Bonds

The admitted value of bonds was determined by this examination to be in the amount of $1,378,803.13 or $19,941.30 less than the amount reported by the Company in its 2003 Annual Statement. The $19,941.30 difference represented the book value of shares in Government Securities Income Fund, a bond mutual fund which the Examiners reclassified as a stock in accordance with *Annual Statement Instructions*.

Bonds were valued in accordance with the *Purposes and Procedures Manual* of the NAIC Valuation of Securities Office. All bonds were investment grade except for a $30,000 issue of Plaquemines LA Port Hbr & Trm Dist. The difference between market and book value of that issue was not considered significant and the Examiners accepted book value as the admitted value for the Plaquemines LA issue. **In the future it is recommended that the Company value all non-investment grade issues of bonds at market value rather than at book value.**

The Examiners obtained confirmations from the custodians and reconciled securities from the confirmations to Company records noting no significant differences.

Accrued interest to December 31, 2003 was reported at $15,596.69. The Examiner recomputed a sample of accrued interest amounts noting no differences.

The following is a list of other reporting differences for bonds noted in Section VII:

<u>Annual Statement Reporting Differences</u>:

- The Company did not report the NAIC Designation of bonds in Column 13 of Section VII, Part 1.
- The Company did not always provide a CUSIP number, the date acquired, the maturity date or the interest rate of bonds. In addition, the information given for those areas did not always agree with supporting documentation.
- The Company did not complete the Schedule of Bonds and Stocks in order, arranged alphabetically, and sub-totaled by group.

The Company did not amortize the premium or discount for most bonds bought at other than par. **It is recommended that the Company record annual adjustments to the book value of bonds to adjust book value to par value at the maturity date of those bonds.**

Not all securities and certificates of deposit are in the Company's new name. **It is recommended that the Company review all investment holdings and make the necessary changes to register all investments in the name of the Company.**

Stocks

The market and admitted value of stocks was determined by this examination to be in the amount of $699,045.35 or $190,491.71 more than the amount reported by the Company in its 2003 Annual Statement. The $190,491.71 difference is composed of the following items and amounts:

	Market Value		
Description	**Company**	**Exam**	**Difference**
Government Securities Income Fund	$ 0	$14,958.00	$ 14,958.00
Federated Prime Obligation Fund	0	7,330.46	7,330.46
Sterne, Agee & Leach, Inc. Money Market Funds	0	159,393.51	159,393.51
Investors Real Estate Trust	51,785.52	60,907.05	9,121.53
Namic Ins. Co.	5,999.41	9,097.62	3,098.21
First Assurance Bancorp	10,000.00	6,590.00	(3,410.00)
Total			$190,491.71

The Examiners reclassified the Government Securities Income Fund from the Bond caption and reclassified the Federated Prime Obligation Fund and money market funds with Sterne, Agee & Leach, Inc., from a write-in caption titled "Money Market Accounts". The former is a bond mutual fund and the latter are money market mutual funds. **It is recommended that the Company report all mutual funds under the Stocks caption in its statutory annual statement.**

The Examiners valued shares in Investors Real Estate Trust at the December 31, 2003, rate per share using the correct number of shares owned rather than at original cost as reported by the Company. The Examiners valued the Namic Insurance Company common stock at the December 31, 2003, rate per share rather than at the undetermined unit price used by the Company. The Examiner valued 200 shares of First Assurance Bancorp at $6,590 using the December 31, 2003, unit price of $32.95 per share assigned by the Securities Valuation Office of the NAIC.

Market value in excess of book value was determined by this examination to be $49,468.30 or $3,826.44 more than the amount reported by the Company.

Real Estate

The Company's investment in real estate at December 31, 2003, consisted of the following parcels:

Home Office Building, Cando, ND	$54,043.61
Office Building, Cando, ND	2,500.00
Office Building, LaMoure, ND	16,798.21
Total	$73,341.82

The Company's home office building was acquired in 2002 at a cost of $51,505.78 and is being depreciated along with permanent improvements over a 25-year period or at the rate of 4% a year.

The office building in Cando was acquired in 1957 and is fully depreciated to the value of the land which was estimated at $2,500.

The Company acquired title to the office building in LaMoure in the 2001 merger with LaMoure-Greenfield Mutual Insurance Company. The original cost of the LaMoure office building was $44,900.19. It is being depreciated at the rate of 4% per year.

The following reporting differences for real estate were noted:

Valuation Exceptions:

- Actual Cost: The Company did not retain a detailed listing showing the items and amounts it capitalized as the actual cost of the home office building purchased in 2002. The Examiners reviewed a listing of expenditures related to the acquisition of the building and determined that original actual cost should have been $47,145.89 or $4,359.89 less than the amount reported by the Company. The Examiners treated the difference of $4,359.89 as a non-admitted asset. **It is recommended that the Company correct its depreciation schedule using the amount determined by this examination of $47,145.89 as the original cost of the home office building.**

Annual Statement Reporting Exceptions:

- Schedule A Column 3: The Company did not always list the name of the seller or supplier of goods or services in Column 3 and it recorded two vendors on the wrong line.

- Schedule A Column 10 – The Company's old home office building in Cando had no rental income in 2003, not $4,847 as reported in Schedule A. Rental income from the office building located in LaMoure, ND was $9,867, not $4,200 as reported. Rent charged by the Company for its own occupancy in its new home office building is identical to the amount charged in the previous home office building which has a lower value than the current home office building. **It is recommended that the Company determine self rent at a rate comparable to rent received from others and/or rental rates of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the carrying value of the reporting entity's investment in its home office building.**

- Schedule A Column 11 - The Company did not complete Column 11 showing gross expenses for each parcel.

Cash

Cash on deposit at December 31, 2003, consisted of the following items and amounts:

Checking Accounts	$209,484.54
Cash on Hand	443.82
Savings Accounts and CDs	357,682.74
Total	$567,611.10

The following differences were noted:

1. Accrued Interest: The Company did not compute accrued interest on certificates of deposit.

2. Supporting Documentation: The Examiners tested a sample of 25 disbursements. In one instance, the Company could not locate adequate documentation for checks.

3. Reporting Inconsistencies: The dates listed on the checks do not match the dates on the Cash Disbursement Journal.

4. Stale-Dated Uncashed Checks: During the period under examination, the Company removed checks over one year old from the outstanding check list through an entry to income. N.D. Cent. Code Chapter 47-30.1 requires the holder to report all unclaimed property, which includes uncashed checks, to the North Dakota Unclaimed Property Division. It does not permit the issuer of uncashed checks to reclaim those funds as its own property as the Company did during the period under examination. The Examiners established a $2,000 reserve for estimated amounts payable to the North Dakota Unclaimed Property Division for uncashed checks erroneously credited to income during the period under examination.

5. The Company did not arrange banks and other institutions alphabetically in Schedule N as required by *County Mutual Annual Statement Instructions*.

It is recommended that the Company retain documents supporting all cash disbursements until the next statutory financial examination of the Company has been finalized.

It is recommended that the Company identify uncashed checks erroneously credited to income during the period under examination and file Abandoned Property forms with the North Dakota Unclaimed Property Division for each of those years.

Uncollected Premiums

Uncollected premiums as reported by the Company and as determined by this examination consisted of the following items and amounts:

Description	Company	Examination
Uncollected Premiums	$30,275.58	$ 38,746.74
Premiums Booked but Deferred and Not Yet Due	0	120,519.71
Total	$30,275.58	$159,266.45

The Examiner determined that the Company understated "Uncollected Premiums" due to the following three items:

- The Company included Advance Premiums in the computation of Uncollected Premiums which had the effect of understating Uncollected Premiums by $13,594.79. The Examiner reclassified Advance Premiums as a liability in this report.
- The Company did not treat uncollected premium balances over 90 days due as a non-admitted asset which had the effect of overstating Uncollected Premiums by $5,123.63. The Examiner treated premiums over 90 days due as a non-admitted asset.
- The Company did not include "Premiums Booked but Deferred and Not Yet Due" in its 2003 Annual Statement which understated ledger and admitted assets by $120,519.71 as a result of that omission. (The Examiner also reclassified uncollected premiums as a ledger asset rather than as a non-ledger asset as reported by the Company.)

It is recommended that the Company:

- **Treat advance premiums as a liability rather than as a reduction to Uncollected Premiums.**
- **Treat premium balances over 90 days due as a non-admitted asset.**
- **Treat uncollected premiums and premiums booked but deferred and not yet due as ledger assets.**

Other Assets

At December 31, 2003, Other Assets consisted of the following items and amounts:

2002 Insurance Agency Acquisition (downpayment)	$ 6,000.00
2003 Insurance Agency Acquisition (final payment)	6,000.00
2003 Insurance Agency Acquisition	10,824.72
2003 Insurance Agency Disposal (installment payment)	(5,000.00)
Total	$17,824.72

The Company purchased the insurance agencies from two of its agents.

In accordance with statutory accounting principles, the Examiner treated the entire amount of $17,824.72 as a non-admitted asset rather than as an admitted asset as treated by the Company. **It is recommended that the Company treat the book value of insurance agencies as a non-admitted asset.**

Furniture, Fixtures and Automobiles

Furniture, fixtures and automobiles consisted of the following items and amounts:

Description	Actual Cost	Accumulated Depreciation	12-31-2003 Book Value
Office Equipment and Fixtures	$122,483.76	$81,297.00	$41,186.76
Automobiles	37,125.00	2,386.61	34,738.39
Unreconciled Difference	0	1,325.90	(1,325.89)
Total	$159,608.76	$85,009.51	$74,599.26

The Company owned seven automobiles at December 31, 2003, all of which were purchased in 2003 and are being depreciated at the rate of 14% per year. The Company depreciates its office equipment and furniture at rates of 10% or 20% per year.

Unpaid Losses

The Company's liability for unpaid losses at year end was determined by this examination to be in the amount of $54,981.43 or $24,101.43 more than that estimated by the Company. The Examiners determined the liability for unpaid losses using subsequent payments through April 15, 2004, the Company's reserve for 2003 and prior incurred claims still open on April 15, 2004, and a $2,500 reserve established by this examination for incurred but not reported claims. The increase is reflected in the changes to "Surplus to Policyholders" of this report.

Unpaid Loss Adjustment Expenses

The Company did not establish a reserve for unpaid loss adjustment expenses. The Examiners established a $2,115 reserve for unpaid loss adjustment expenses using subsequent payments and a percentage of paid losses for in-house adjustments. **It is recommended that the Company establish a reserve for loss adjustment expenses in its statutory annual statement.**

Unearned Premiums

The liability for unearned premiums was determined by this examination to be $858,541.88 or $18,243.38 more than the amount reported by the Company. The differences are reflected in the following schedule:

Coverage	Company	Exam	Difference
Fire	$404,040.56	$404,040.56	
Pollution	0	484.48	$ 484.48
Woodburning Stove	1,470.68	1,470.68	0
Policy Fee	35,875.50	4,100.00	(31,775.50)
Wind	379,739.84	379,739.84	0
Scheduled Personal Property	17,786.50	17,786.50	0
Liability	0	0	0
Other	1,385.42	1,385.42	0
Subtotal	$840,298.50	$809,007.48	$(31,291.02)
LaMoure-Greenfield Business	0	39,544.40	39,544.40
Adjustment for Uncollected Premiums	0	9,990.00	9,990.00
Totals	$840,298.50	$858,541.88	$ 18,243.38

The unearned premiums by lines of business shown in the foregoing schedule were generated by the Oasis accounting program using the daily pro-rata method. The unearned premiums for LaMoure-Greenfield business was computed by the Examiner using the semi-monthly pro-rata basis. The examination adjustments to unearned premiums consist of the following items:

1. The Company does not return policy fees to the insured in the event of policy cancellation; therefore, policy fees were considered fully earned and no unearned premium for that item was established by this examination, except for policy fees included in the asset "Premiums Booked but Deferred and Not Yet Due".

2. The Company writes pollution on a direct basis; therefore, an unearned premium reserve is applicable.

3. The Examiners established an unearned premium reserve for business formerly issued by LaMoure-Greenfield County Mutual Insurance Company. The Company processed the old LaMoure-Greenfield business on a different system and that business was not included in the December 31, 2003, unearned premium report generated by Oasis. The Company inadvertently forgot to include the unearned premium reserve for the LaMoure-Greenfield business in its 2003 Annual Statement.

4. The information on the Uncollected Premium report was not consistent with the Premium In-Force report and as a result the Company understated December 31, 2003, unearned premiums by an amount estimated by the Examiners to be $9,990. The understatement was caused because the unearned premium report, which was generated at a later time than the uncollected premium report, was not prepared using the same transactions as those used when the uncollected

premium report was generated. **It is recommended that the Company run the year-end Uncollected Premium report and the Unearned Premium report on the same day as shortly after year-end as possible to insure that both reports are generated using the same transactions.**

Commissions Due and Payable to Agents

The liability for commissions payable to agents consisted of the following items and amounts:

December 2003 Commissions	$21,891.60
Contingent Commissions	39,673.05
Commissions on Deferred Installments	16,914.31
Total	$78,478.96

The first two amounts were determined from subsequent payments. The third item, commissions on deferred installments, represents commissions on premiums booked but deferred and not yet due which the Examiners established as a ledger asset in the amount of $120,519.

The liability for unpaid commissions as determined by this examination is $52,841.00 more than the amount reported by the Company in its 2003 Annual Statement. The difference consists primarily of the latter two items which the Company did not include in its reported liability for commissions due and payable.

Unpaid Taxes

The liability for unpaid taxes was determined by this examination to be $30,364.40 or $18,077.56 more than that reported by the Company. The following schedule reflects the Company's liability, the liability determined by this examination and the differences therefrom:

Description	Company	Examination	Difference
Medicare Withheld	$ 257.54		$ (257.54)
State Income Tax Withheld	234.30		(234.30)
Payroll Taxes		$ 1,441.21	1,441.21
Federal Unemployment Taxes		73.65	73.65
Real Estate Taxes		2,488.01	2,488.01
Premium Taxes	11,795.00	26,361.53	14,566.53
Totals	$12,286.84	$30,364.40	$18,077.56

The liability for unpaid taxes was determined by this examination from a review of subsequent payments and from a recomputation of the Company's premium tax returns for the period under examination. The $14,566.53 adjustment to premium taxes was due primarily to the inclusion of liability premiums in the computation of premium taxes.

Unpaid General Expenses

The liability for unpaid general expenses at December 31, 2003, was determined by this examination to be $11,812.29 or $16,378.64 less than the amount reported by the Company.

The examination reduction to this caption is due mainly to the reclassification of the Company's reported liability for December 2003 "Reinsurance Premiums Due and Payable" to its separate caption.

Reinsurance Premiums Due and Payable

The Company's liability for reinsurance premiums payable at December 31, 2003, was determined by this examination to be in the amount of $31,824.23 or $31,824.23 more than that reported the Company. **It is recommended that the Company report the liability for "Reinsurance Premiums Due and Payable" on line 39 of page 3 rather than under the liability for "Unpaid General Expenses."**

Advance Premiums

The Examiners reclassified advance premiums as a liability rather than as a reduction to Uncollected Premiums as reported by the Company. Advance premiums were determined by this examination to be in the amount of $13,594.79. **It is recommended that the Company report Advance Premiums as a liability rather than as a reduction to Uncollected Premiums.**

Amounts Withheld for Account of Others

The liability for amounts withheld for account of others consisted of the following items and amounts:

Federal Income Taxes and FICA Taxes Withheld	$3,310.32
State Income Taxes Withheld	774.42
Total	$4,084.74

The Company did not establish a liability for "Amounts Withheld for Account of Others". **It is recommended that the Company establish a liability for "Amounts Withheld for Account of Others" when applicable.**

Federal Income Taxes Payable

In 2003, the Company made federal income tax installment payments of $77,600 for year 2003. It estimated its federal income taxes for year 2003 would be approximately $82,600. The Examiners established a $5,000 liability for "Federal Income Taxes Payable" based on the $82,600 estimate less the 2003 installment payments of $77,600. The Company did not establish a liability for federal income taxes payable in its 2003 Annual Statement.

Stale-Dated Uncashed Checks

The Examiners established an estimated liability of $2,000 for outstanding checks erroneously written off to income by the Company during the period under examination.

Surplus to Policyholders

Surplus to policyholders was determined by this examination to be in the amount of $1,797,216.92 or $44,870.90 less than the amount reported by the Company. Adjustments to surplus are shown in the following schedule:

Description	Company	Examination	Increase (Decrease) to Surplus
Ledger Assets:			
Bonds	$1,398,744.43	$1,378,803.13	$(19,941.30)
Stocks	462,911.78	649,577.05	186,665.27
Money Market Accounts	166,723.97	0	(166,723.97)
Uncollected Premiums		43,870.37	43,870.37
Premiums Booked but Deferred and Not Yet Due		120,519.71	120,519.71
Non-Ledger Assets:			
Premiums in Course of Collection	30,275.58	0	(30,275.58)
Market Value of Stocks over Book	45,641.86	49,468.30	3,826.44
Non-Admitted Assets:			
Premiums over 90 Days Due		5,123.63	(5,123.63)
Other Assets		17,824.72	(17,824.72)
Real Estate		4,360.00	(4,360.00)
Liabilities:			
Unpaid Losses	30,880.00	54,981.43	(24,101.43)
Unpaid Loss Adjustment Expenses		2,115.00	(2,115.00)
Unearned Premium Reserve	840,298.50	858,541.88	(18,243.38)
Commissions Due and Payable	25,637.96	78,478.96	(52,841.00)
Unpaid Taxes	12,286.84	30,364.40	(18,077.56)
Unpaid General Expenses	28,190.93	11,812.29	16,378.64
Reinsurance Premiums Due		31,824.23	(31,824.23)
Amounts Withheld		4,084.74	(4,084.74)
Advance Premiums		13,594.79	(13,594.79)
Federal Income Taxes		5,000.00	(5,000.00)
Stale-Dated Outstanding Checks		2,000.00	(2,000.00)
Net Decrease			$(44,870.90)

CONCLUSION

The financial condition of Northeast Mutual Insurance Company, Cando, North Dakota, as determined by this examination as of December 31, 2003, is summarized as follows:

TOTAL ADMITTED ASSETS		$2,890,014.64
Total Liabilities	$1,092,797.72	
Surplus to Policyholders	1,797,216.92	
TOTAL LIABILITIES AND SURPLUS		$2,890,014.64

The courteous cooperation extended by the officers and employees of the Company during the course of the examination is gratefully acknowledged.

In addition to the undersigned, Rhoda Sautner, CPA, participated in this examination.

Respectfully submitted,

David Weiss, CFE
Examiner
N.D. Insurance Department

COMMENTS AND RECOMMENDATIONS

It is recommended that the Company implement a procedure pursuant to N.D. Admin. Code § 45-03-12-05 to provide for quarterly authorization of investment transactions by the Board of Directors.

It is recommended that no loan be made unless the loan first has been authorized by the Board of Directors or a Board-appointed Investment Committee.

It is recommended that the Company and RMS enter into a facilities management and service agreement which includes a description of the services provided, the method used to determine the cost of those services and payment terms.

It is recommended that the Company maintain a separate recordkeeping system for RMS and that the Company report only the financial transactions and balances for the Company's operations and activities in its statutory annual statement.

It is recommended that the Company increase its fidelity bond to the $75,000 amount recommended by the NAIC.

It is recommended that the Company amend the reinsurance agreement with Grinnell Mutual Reinsurance Company to include an "entire contract" clause.

It is recommended that the Company eliminate the manual recordkeeping system and strive to record all transactions in Oasis. It is also recommended that the Company establish clear job duties and responsibilities which will create an environment conducive to producing reliable accounting records.

It is recommended that the Company report only claim adjustment expenses on line 20 in accordance with C*ounty Mutual Annual Statement Instructions.*

It is recommended that the Company maintain adequate records and workpapers to support the detail of all accounting transactions, enabling verification of the year-end statement values. Company management should perform a periodic review to determine that these records are accurate, sufficiently detailed, and retained in orderly, safe storage with appropriate retention periods.

It is recommended that the Company establish a capitalization policy for real estate and furniture, fixture and automobiles that excludes all items under $100 and expenditures with a useful life of less than one year.

It is recommended that the Company limit the number of employees authorized to withdraw funds from the checking account to no more than two employees authorized by the Board of Directors. It is recommended that the Company require two signatures on all checks, or on all checks in excess of a minimum amount established by the Board. The Examiners also recommend that the Company prohibit issuing checks to cash.

It is recommended that the bank reconciliation be prepared by someone who does not record transactions and does not issue checks.

It is recommended that the Company evaluate the financial condition and capability of the custodian of its securities before establishing a business relationship and on a periodic basis while continuing the business relationship.

It is recommended that the Company thoroughly review the *Annual Statement Instructions* to insure that its annual statement is completed in accordance with those instructions.

In the future it is recommended that the Company value all non-investment grade issues of bonds at market value rather than at book value.

It is recommended that the Company record annual adjustments to the book value of bonds to adjust book value to par value at the maturity date of those bonds.

It is recommended that the Company review all investment holdings and make the necessary changes to register all investments in the name of the Company.

It is recommended that the Company report all mutual funds under the Stocks caption in its statutory annual statement.

It is recommended that the Company correct its depreciation schedule using the amount determined by this examination of $47,145.89 as the original cost of the home office building.

It is recommended that the Company determine self rent at a rate comparable to rent received from others and/or rental rates of like property in the same area. If this is unavailable, it shall be derived from consideration of the repairs, expenses, taxes, and depreciation incurred, plus interest added at an average fair rate on the carrying value of the reporting entity's investment in its home office building.

It is recommended that the Company retain documents supporting all cash disbursements until the next statutory financial examination of the Company has been finalized.

It is recommended that the Company identify uncashed checks erroneously credited to income during the period under examination and file Abandoned Property forms with the North Dakota Unclaimed Property Division for each of those years.

It is recommended that the Company:

- Treat advance premiums as a liability rather than as a reduction to Uncollected Premiums.
- Treat premium balances over 90 days due as a non-admitted asset.
- Treat uncollected premiums and premiums booked but deferred and not yet due as ledger assets.

It is recommended that the Company treat the book value of insurance agencies as a non-admitted asset.

It is recommended that the Company establish a reserve for loss adjustment expenses in its statutory annual statement.

It is recommended that the Company run the year-end Uncollected Premium report and the Unearned Premium report on the same day as shortly after year-end as possible to insure that both reports are generated using the same transactions.

It is recommended that the Company report the liability for “Reinsurance Premiums Due and Payable” on line 39 of page 3 rather than under the liability for “Unpaid General Expenses.”

It is recommended that the Company report Advance Premiums as a liability rather than as a reduction to Uncollected Premiums.

It is recommended that the Company establish a liability for “Amounts Withheld for Account of Others.”